FOR ARGUMENT

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In the Supreme Court of the United States

OCTOBER TERM, 1979

PETER E. AARON, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MOTION OF THE SECURITIES AND EXCHANGE COMMISSION FOR LEAVE TO FILE A SUPPLEMENTAL BRIEF

AND

SUPPLEMENTAL BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

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The Solicitor General, on behalf of the Securities and Exchange Commission, moves for leave to file the attached supplemental brief responding to certain arguments raised by the Securities Industry Association ("SIA") in its amicus curiae brief filed in support of petitioner.

The SIA submitted its amicus brief to this Court on January 9, 1980, the day on which the Commission's brief was filed and forty days after petitioner's brief was filed and the SIA's brief was due. The Commission did not consent to the filing of the SIA's brief because the Commission's brief was in page-proof form when counsel for the Commission first received a draft of the SIA's

brief. It was therefore impossible for the Commission to respond to the arguments raised by the SIA. The Court granted the SIA's motion to file its brief on January 21, 1980.

The SIA's brief purports to focus on "issues and authorities not covered in the other briefs" filed in this case in support of petitioner. Motion of the Securities Industry Association for Leave to File a Brief *Amicus Curiae* 3. Accordingly, the Commission seeks leave to file the attached supplemental brief to respond to certain arguments raised by the SIA that have not been raised by petitioner and other amici.

Respectfully submitted.

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SUPPLEMENTAL BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

1. The Securities Industry Association ("SIA") argues that use of the word "fraudulent" in the title of Section 17(a) limits all three subparagraphs of that provision to intentional misconduct (SIA Br. 14-16). The SIA further argues (*ibid.*) that the language of subparagraphs (1) and (3) of Section 17(a) require scienter and that, under the doctrine of *ejusdem generis*, subparagraph (2) should also be so limited.

However, the title of Section 17(a)—"Fraudulent Interstate Transactions"—cannot "take the place of" or "limit the plain meaning of the text" of the statute. *Brotherhood of Railroad Trainmen* v. *Baltimore & Ohio Railroad Co.*, 331 U.S. 519, 528-529 (1947). Moreover, the use of the word "fraudulent" does not imply a

congressional intent to require scienter in an injunctive proceeding. As discussed at length in our initial brief (Br. 23-35), the word "fraud" has a broader meaning in equity than at law, and the word does not require proof of scienter in this context. See *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 192-195 (1963).[1]

The SIA's *ejusdem generis* argument concerning the three subparagraphs of Section 17(a) is foreclosed by *United States* v. *Naftalin*, 441 U.S. 768, 773-774 (1979), which held that each subparagraph of Section 17(a) is intended to proscribe a "distinct category of misconduct." The Court explained in *Naftalin* that limitations on one subparagraph of Section 17(a) are not intended "to narrow the reach" of the others.

Finally, as we noted in our initial brief (Br. 30-35, 37-38 & n.17), nothing in the language of subparagraph (3) of Section 17(a) suggests a scienter requirement.[2] *Capital Gains*, which considered substantially identical language, is dispositive of SIA's contrary argument. Nor should scienter be required under subparagraph (1), because Congress considered and rejected a scienter requirement under that provision.[3]

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[1]New York's Martin Act was entitled "Fraudulent Practices in Respect to Stocks, Bonds and other Securities." N.Y. Gen. Bus. Law §§ 352-353 (Consol. 1921). As noted in our initial brief (Br. 28), this provision—which served as a model for Section 17(a)—was never interpreted to require scienter.

[2]Contrary to the SIA's assertion (Br. 15), *Steadman* v. *SEC*, 603 F. 2d 1126, 1133 (5th Cir. 1979), held that (emphasis supplied): "scienter need not be proved to establish violations of subsections 17(a)(2) *and* (3)."

[3]In several proposed versions of Section 17(a), the phrase "with the intent to defraud" would have applied to (and *only* to) the clause that became subparagraph (1). See our initial brief at pages 40-41 & n. 20; S. 875, 73d Cong., 1st Sess. §13 (Apr. 14, 1933) (Confidential Committee Print No. 2); S. 875, 73d Cong., 1st Sess. §13 (Apr. 18, 1933) (Confidential Committee Print No. 3); S. 875, 73d Cong., 1st Sess. §13 (Apr. 26, 1933) (Confidential Committee Print No. 4). In addition to eliminating this language, Congress eliminated the word "willfully," which would have imposed a state of mind requirement under subparagraph (1). See our initial brief at pages 39-42.

2. The SIA also argues (Br. 16-18) that Congress' rejection of the words "willfully" and "intent to defraud" in drafting Section 17(a) is not significant. It is true that the Conference Committee that adopted the House version of Section 17(a) did not explain its reasons for eliminating these words (which appeared in the Senate version of Section 17(a)). But that hardly suggests that the elimination was inadvertent.

The House bill, which as reported did not include the words "willfully" and "intent to defraud," was used by the conferees as their working draft. The Senate bill was rarely mentioned in conference discussions. See Landis, *The Legislative History of the Securities Act of 1933*, 28 Geo. Wash. L. Rev. 29, 39, 45 (1959). The House version of Section 17(a) was not amended by the Conference Committee and thus did not require discussion.[4] Moreover, the Conference Report did not undertake to discuss all of the "[n]umerous differences between the House Bill and the Senate amendment * * * about the powers of the * * * Commission." H.R. Conf. Rep. No. 152, 73d Cong., 1st Sess. 27 (1933).

The conferees knew full well that their decision to delete the words "willfully" and "intent to defraud" was

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[4]As the SIA notes (Br. 18), the Conference Report purports to discuss the "differences between the House bill and *the substitute agreed upon by the conferees*" (emphasis supplied). It does not purport to discuss every element of the *Senate* bill that was rejected.

significant. The subject of "willfulness" received "extended discussion by the Congressional Committees" when criminal prosecutions under the Securities Act were considered (see Herlands, *Criminal Law Aspects of the Securities Act of 1933*, 67 U. S. L. Rev. 562, 565 (1933); see also *id.* at 565-567 n. 7). The conferees were well aware that the word "willfully" would impose a state of mind requirement. See 77 Cong. Rec. 2994 (1933) (remarks of Sen. Fletcher); 77 Cong. Rec. 2919 (1933) (remarks of Rep. Rayburn). And the phrase "intent to defraud," which also was rejected in conference, plainly would have required scienter in an injunctive proceeding. Under these circumstances, creation of a scienter requirement under Section 17(a) by judicial interpretation would result in the imposition of the very standard that Congress deliberately omitted.

The SIA also claims (Br. 16-17) that scienter should be required because the House Report states that Section 17(a) prohibits "any device, scheme, or artifice to defraud." The .SIA contends that this is the only legislative history discussing the scope of Section 17(a).[5] However, the House Report was merely reciting the statutory language of one subparagraph of Section 17(a). The Report later discusses the coverage of Section 17(a) by referring comprehensively to all three of its subparagraphs. H.R. Rep. No. 85, 73d Cong., 1st Sess. 24 (1933).

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[5] *Federal Securities Act: Hearing on H.R. 4314 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 1st Sess. 109 (1933) (noting that Section 17(a) is similar to New York's Martin Act); *id.* at 240-241 (remarks of Judge Healy) (suggesting that the power granted under Section 17(a) to enjoin "fraud or misrepresentation" be transferred from the Attorney General to the Commission).

3. The SIA argues from the structure of the securities laws (Br. 19) that Congress has expressly indicated the situations in which liability may be based on negligence.[6] This structure, in the SIA's view, supports the argument that negligent deception cannot be enjoined under Sections 17(a) and 20(b) of the Securities Act. But this contention ignores the fact that, throughout the securities laws, Congress has generally authorized the Commission to seek injunctive relief without imposing any culpability requirement. Congress has relied instead on the traditional discretionary powers of courts of equity to determine when relief is appropriate.[7]

4. The SIA also argues (Br. 24-26) that permitting injunctive remedies under Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act without proof of scienter would defeat the requirements of Section 15(b)(4) of the Securities Exchange Act, 15 U.S.C. 78*o*(b)(4), by permitting the imposition of administrative sanctions without a showing of "willfulness." However, Section 15(b)(4) allows the Commission to impose sanctions (when consistent with

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[6] The SIA premises its comparative analysis on *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 200 (1976). But *Hochfelder* sought to harmonize implied and express *damage* remedies. Here, by contrast, the SIA seeks to equate statutory provisions authorizing injunctions with other statutory provisions authorizing private damage remedies and administrative relief. This is not a fruitful comparison. As noted in our initial brief (Br. 23-25), the law historically has drawn a sharp distinction between injunctive relief and money damage remedies.

[7] The Commission's argument does not, as the SIA asserts (Br. 16), lead to liability for wholly faultless conduct. Courts have granted injunctive relief only when it is anticipated that misconduct is likely to recur. The degree of culpability is one of many factors to be considered in making this determination. See our initial brief at pages 64-65, 74-75.

the public interest) when a broker or dealer commits violations "willfully" (Section 15(b)(4)(D)) *or* when the broker or dealer has been "permanently or temporarily enjoined * * * from engaging in or continuing any conduct or practice in connection with * * * the purchase or sale of any security" (Section 15(b)(4)(C)). "Willfulness" is not an express requirement under subparagraph (C) and should not be made a requirement by implication. *Shuck* v. *SEC*, 264 F. 2d 358, 361-362 (D.C. Cir. 1958). The SIA's contrary interpretation would make subparagraph (C) superfluous, because willful violations of the law can serve as the basis for sanctions even when no injunction has been issued. See *id.* at 362.[8]

We also note that Section 15(b) was not added to the Securities Exchange Act until 1936. There is no evidence that Congress intended at that time to narrow the scope of the injunctive remedies previously provided under the Securities Act and the Securities Exchange Act. See our initial brief at page 72 & n.40. See also *United States* v. *Naftalin*, *supra*, 441 U.S. at 777 n.8 ("subsequent enactments do not serve to restrict the original scope of §17(a)").

Nor is there merit to the SIA's assertion (Br. 24-25) that severe sanctions will be imposed under Section 15(b)(4) on the basis of an injunction alone when the circumstances do not require such administrative action. As discussed in our initial brief (Br. 76), the Commission

[8]The SIA suggests (Br. 25 n.4), without citation of supporting authority, that Congress in enacting Section 15(b)(4)(C) did not intend the issuance of an injunction to serve as an "alternative standard of liability" but only intended to avoid the necessity of relitigating issues resolved in an injunctive proceeding. This suggestion is without merit because a defendant is collaterally estopped from relitigating findings of fact made in connection with the entry of a permanent injunction.

cannot impose a sanction unless it finds after a hearing that the sanction is "in the public interest." This is true even if the defendant broker-dealer has already been enjoined from engaging in deceptive securities practices. There is no reason to assume that the Commission will refuse to consider all relevant factors, including the degree of the defendant's culpability, before making such a determination. Should the Commission act arbitrarily, such administrative action would not withstand judicial review.

5. The SIA contends (Br. 29, 31) that the business of a broker-dealer is based on trust and confidence and that an injunction resulting from negligent deception of customers could "mar[ ] the record and reputation of a broker-dealer." But in such circumstances, when the broker-dealer's negligence has misled customers and there is a cognizable danger of repetition of deception, it is not the Commission's action that threatens the defendant's reputation. The trust that investors place in fiduciaries such as brokers is hardly a reason for eliminating the requirement that they act with reasonable care or for disregarding negligent deception. As noted in our initial brief (Br. 69-72), careless and imprudent conduct of securities dealers contributed to the market crash of 1929. History teaches that investor confidence is essential to the vigor of the national securities markets and that investors need protection from broker-dealers who mislead their clients through negligent behavior.

The SIA also argues (Br. 6, 29, 31-32) that application of a negligence standard under Sections 17(a) and 10(b) would result in a "proliferation of SEC injunction actions" and adverse collateral consequences for broker-dealers. But collateral consequences are not a reason for permitting negligent broker-dealers to continue to

deceive investors. Moreover, as we have previously noted (Br. 38-39 n.17, 48, 68-69), the courts of appeals have long applied a negligence standard in injunctive actions under both Sections 17(a) and 10(b). Brokers can also be required to exercise due care under other provisions of the securities laws. See Section 9(a)(4) of the Securities Exchange Act, 15 U.S.C. 78i(a)(4) (prohibiting negligent misrepresentations by brokers or dealers who recommend securities transactions on exchanges); Section 15(c)(2) of the Securities Exchange Act, 15 U.S.C. 78*o*(c)(2) (empowering the Commission to adopt rules to forbid acts in the over-the-counter market that are conducive to fraud even though such acts are not themselves fraudulent). See also *Regulation of Over-the-Counter-Markets: Hearings on S. 3255, H.R. 9634, Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce*, 75th Cong., 3d Sess. 38-41, 50, 54-55 (1938).

In sum, the negligence standard applicable in injunctive actions under Sections 17(a) and 10(b) does not impose novel requirements. It imposes duties that are comparable to those imposed by other related provisions of the securities laws.

6. The SIA also argues (Br. 33-40) that this Court should give the lower federal courts guidance on the scope of injunctive remedies. It contends that the Court should prescribe requirements for injunctive relief in addition to the finding of a substantive violation of the securities laws (Br. 34)[9] and that it should expound upon

[9]The SIA claims (Br. 35) that "Congress has repeatedly rejected attempts by the Commission to expand its powers * * * to file for injunctions upon the basis of past misconduct alone" and suggests that the Court should instruct the lower courts that an injunction should not issue solely on that basis. But there is no need for such instruction. The lower courts do not automatically grant injunctions simply because of past violations of the securities laws. See Pet. App. 45a.

Moreover, despite the SIA's suggestion that there have been unsuccessful attempts to alter the standards for injunctive relief through legislation, Congress rejected the proposed legislation, not because it would have expanded, but rather because it would have merely restated, existing law. In 1960 and 1975, Congress found such proposed legislation to be unnecessary, expressing its agreement with the long-standing judicial interpretation of the "present statutory language" that permits a court, in the exercise of its "historic equity discretion," to consider evidence of past violations as showing the "existence of some cognizable danger of recurrent violation." S. Rep. No. 1756, 86th Cong., 2d Sess. 4 (1960). See also H.R. Rep. No. 94-229, 94th Cong., 1st Sess. 102 (1975) ("existing law does not require clarification in these respects"); S. Rep. No. 1757, 86th Cong., 2d Sess. 9 (1960); H.R. Rep. No. 2180, 86th Cong., 2d Sess. 5 (1960).

[10]Although the SIA argues that injunctive orders should not track the language of the statutory provision involved, petitioner has not raised this objection here or in the lower courts. The only difference between the injunction issued and the injunction proposed by petitioner is the inclusion of the words "or any other securities." See SIA Br. 37. The SIA's objection (Br. 8) to that language is without merit. "A federal court has broad power to restrain acts which are of the same type or class as unlawful acts which the court has found to have been committed or whose commission in the future, unless enjoined, may fairly be anticipated from the defendant's conduct in the past." *NLRB* v. *Express Publishing Co.*, 312 U.S. 426, 435 (1941). An injunction limited to a particular security would be "so narrow as to invite easy evasion." *McComb* v. *Jacksonville Paper Co.*, 336 U.S. 187, 193 (1949).

the proper form of injunctive orders (*id.* at 37-40).[10] However, these questions were not encompassed by the grant of certiorari in the present case and are unrelated to the questions briefed by the parties. Under these circumstances, the Court need not address the issues that the SIA belatedly seeks to interject.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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